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No. 76-635

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

UNITED STATES STEEL CORPORATION, *et al.*
ON BEHALF OF THEMSELVES AND ALL PERSONS
SIMILARLY SITUATED, *Appellants,*
v.
MULTISTATE TAX COMMISSION, *et al., Appellees.*

On Appeal from the United States District Court for the Southern District of New York

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REPLY BRIEF FOR APPELLANTS

ERWIN N. GRISWOLD
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036
THOMAS McGANNEY
14 Wall Street
New York, New York 10005
Attorneys for Appellants

Of Counsel:

RAYMOND J. WIACEK
JONES, DAY, REAVIS & POGUE
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036

RICHARD A. HOPPE
TODD B. SOLLIS
WHITE & CASE
14 Wall Street
New York, New York 10005

SHEARMAN & STERLING
53 Wall Street
New York, New York 10005

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REPLY BRIEF FOR APPELLANTS

I

THE PRACTICE OF CONGRESS AND THE STATES

The appellees ignore the clearly established practice of Congress in reviewing and approving interstate compacts, as documented in Supplement A and Supplement B to appellants' main brief (pp. 53-120). Instead, they continue to rest their case on the dicta of Mr. Justice Field in *Virginia* v. *Tennessee,* 148 U.S.

503 (1893), where the facts raised a much narrower issue than is involved here. That case involved a one-time, one-place boundary agreement which, as Justice Field said, did not increase "the political power or influence of the states affected." 148 U.S. at 520.[1] The appellees also cite other relatively narrow cases which rely on *Virginia* v. *Tennessee*.

The appellees now contend that "advisory" or "cooperative" agreements (Br. 36) should be added to those which do not require the consent of Congress. On this basis, they argue that the Multistate Tax Compact is valid though Congress has never given its approval. This argument is made even though Congress has considered and approved many such compacts, and has been particularly thorough in examining the operations and potential impact of such compacts, often requiring annual reports, consent to amendments or addition of new members, federal participation, and limited duration unless further consent is obtained.[2]

[1] Even interstate boundary disputes may involve strong national interests. A well-known example is the "Toledo War," arising out of the location of the Ohio-Michigan boundary. See Arthur M. Schlesinger, "Basis of the Ohio-Michigan Boundary Dispute," in the Ohio-Michigan Boundary—Final Report of the Ohio Cooperative Topographic Survey (1916), vol. 1, pp. 59-115; Carl Wittke, "The Ohio-Michigan Boundary Dispute Re-Examined," Ohio State Archeological and Historical Quarterly, October, 1936. This dispute was settled through congressional action. Ohio received the Toledo area, and Michigan was given much of its northern peninsula in recompense.

[2] Appellees offer no comment on the approximately 150 compacts reviewed and approved by Congress, nor do they refer to the many safeguards Congress has employed in approving ongoing, multistate agreements like the Compact now before the Court. Appellees refer only to the hearings before Congress on the Southern Regional Education Compact. (Br. 33.) The lack of consent given this Compact is readily explainable. The Compact was seen as a device to avoid impending school integration in the South. When civil rights leaders informed the Senate that its consent would be an affirmation of this device, and would affect civil rights litigation pending in federal courts in Texas, Oklahoma, South Carolina, and Louisiana, Justice Field's remarks were used as a means of avoiding such affirmation. (The House had already reviewed and consented to the Compact, pursuant to Article I, Section 10.) When a state court later held that the Compact could not be used to avoid integration, *McCready* v. *Byrd*, 195 Md. 131, 73 A.2d 8 (1950), *cert. denied*, 340 U.S. 827 (1950), interest in the Compact waned, and it was never brought back to Congress. *See* Barton, Interstate Compacts in the Political Process (1967) 129-34; Sugg & Jones, The Southern Regional Education Board: Ten Years of Regional Cooperation on Higher Education (1960); Thursby, Interstate Cooperation: A Study of the Interstate Compact (1953) 113-23, 129-34.

The argument is also made in the face of several unsuccessful attempts to obtain congressional approval for the Multistate Tax Compact, and despite the fact that all of the member states belong to "advisory" or "cooperative" compacts for which congressional review and consent has been sought and obtained.

The position of the appellees leaves little scope for Article I, Section 10, despite the fact that the well-established practice of Congress, and of all the participating states, shows that it is understood to have wide effect. As their explanation of the scope of Article I, Section 10, appellees refer (Br. 36) to—

> the distinction between cooperative agreements, such as the Compact in question, which do not require congressional consent, and conflict-resolving agreements which might require consent . . . .

They offer (Br. 35) as an example of a conflict-resolving agreement a "typical border dispute." Yet this is just the reverse of *Virginia* v. *Tennessee* and the congressional practice with respect to compacts. Under appellees' arguments, boundary and other dispositive,

"conflict-resolving" agreements would require consent, despite the result in *Virginia* v. *Tennessee* and despite appellees' reliance on that result in arguing for the exemption of the Multistate Tax Compact; while "advisory" or "cooperative" compacts, which have been consistently reviewed by Congress and which have never been upheld by this Court in the absence of congressional consent, would be exempted from the consent requirement.

II

THE COMPACT HAS SUBSTANCE AND IMPACT

The appellees also seek to create the impression that the Compact and Multistate Tax Commission are without effect, and almost nonexistent as separate entities. The Compact is compared to uniform legislation (Br. 17, 44, 45), and the observation is made that such legislation need not be approved by Congress. Of course, uniform legislation does not require seven states to join before it is effective, as did the Compact, nor need a state "withdraw" from uniform legislation. Moreover, the member states of the Compact knew they were joining an interstate compact. The enabling legislation in most states specifically provides that the Compact is *adopted and entered into* with all other member states.

Wyoming, for example, authorized its Governor to negotiate and enter into the Compact on behalf of the state, adopting the language and practice common to treaties. Washington also employed treaty language, "entering into," "approving," and "ratifying" the Compact. Colorado placed the Compact in a separate article, far from its revenue laws, entitled "Interstate

Compacts and Agreements." This article is part of the title codifying the structure of Colorado's government, and lists the other compacts to which Colorado belongs, including other "cooperative" or "advisory" compacts which have received the consent of Congress. Michigan also placed the Compact in a chapter entitled "Interstate Activities," which compiles the other compacts in which Michigan is a member.[3]

Thus, it is hardly appropriate at this late date to argue that the Compact does not exist—that it has no substance or impact. It is, both in form and effect, a substantial agreement among the states, coming well within the words and substance of Article I, Section 10. It was called a compact by its draftsmen; it is called a compact today and throughout the appellees' brief; it is intended to be a compact; it was brought before Congress seeking approval as a compact; and it is acting as a compact.

The appellees also urge the Court to ignore or minimize the operations and existence of the Multistate Tax Commission. (Br. 6, 11, 13, 15, 43, 57, 77, 78.) The Commission is compared to a voluntary organization like the American Bar Association ("ABA"). (Br. 10, 60, 61.) As this Court knows, however, voluntary organizations like the ABA may not compel citizens to comply with their commands regarding the production of records, documents, and personnel in order to formulate "advice," as the Commission may do pursuant to the subpoena powers granted it by its members.[4] The

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[3] The state code citations appear in appellants' brief 4. The correct citation for Colorado is Colo. Rev. Stat. 1973, Art. 24-60-1301.

[4] The appellees claim repeatedly that the Commission is without

ABA, for example, has never forced citizens to produce all worldwide financial records so that it could issue a "recommendation."

The simple fact is that the Commission is different from organizations like the ABA. It is the official body of a multistate compact, formed by and adopted into the laws of nineteen states, and cloaked with government authority, though with minimal governmental responsibility. It develops tax regulations and conducts multistate and multinational tax audits that are an integral part of the governmental function of taxation. It is empowered to issue its own subpoenas and utilize the full authority of the state courts throughout the region united by the Compact, and it has in fact issued subpoenas and sued in its own name to compel the production of private records.

Appellees also argue that because the member states of the Compact can adopt tax regulations and conduct audits on an individual basis, they must be allowed to pursue such activity on a concerted basis. (Br. 15, 42, 43, 44.) However, the law has always recognized that concerted activity may present dangers that individual

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power. (Br. 6, 11, 13, 15, 43, 57, 77, 78.) However, Article VIII of the Compact states, in part:

> "3. The Commission may require the attendance of any person within the State where it is conducting an audit or part thereof at a time and place fixed by it within such State for the purpose of giving testimony with respect to any account, book, paper, document, other record, property or stock of merchandise being examined in connection with the audit. If the person is not within the jurisdiction, he may be required to attend for such purpose at any time and place fixed by the Commission within the State of which he is a resident; provided that such State has adopted this Article." (Jur. St. App. E, pp. 54a, 72a-73a.)

action would not.[5] Moreover, requiring groups of states to obtain the consent of Congress for activities that arguably could be undertaken individually does not represent a sudden or unwarranted shift of power to the Federal Government. As noted above, the consent of Congress has been sought and obtained for almost every compact formed since the founding of the Nation, and thus a decision requiring the Multistate Tax Compact similarly to seek such consent does not constitute a shift in power or policy. All of the states appearing as *amici curiae*, and all of the states of the Compact, have sought and obtained the consent of Congress as members of interstate compacts without experiencing a sudden loss of power and without destroying their ability to cooperate with each other. It should also be noted that, regardless of the decision in this case, the states appearing as *amici curiae* can continue to enact uniform legislation without approaching Congress, and their state officials can continue to join the ABA.

Finally, the appellees again argue that the Compact does not require congressional consent because it is cast in an "advisory" and "voluntary" form. (Br. 6, 15, 17, 36, 43, 44, 58.) To support this argument, the appellees would limit the consideration of this Court to the words of the Compact "on its face," in an attempt to prevent this Court from considering the potential effects presented—and already realized—under

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[5] *See* Hawkins, Pleas of the Crown, 6 ed., bk. 1, ch. 72, sec. 2. *See also Rex* v. *Starling*, 1 Sid. 174 (1665); *Rex* v. *Delaval*, 3 Burr. 1434 (1763). For U.S. cases, *see, e.g., Grenada Lumber Co.* v. *Mississippi*, 217 U.S. 433, 440 (1910); *Eastern States Lumber Ass'n* v. *United States*, 234 U.S. 600, 614 (1914); *FTC* v. *Raymond Bros.-Clark Co.*, 263 U.S. 565, 574 (1924).

the Compact.[6] Thus, appellees would note only that the multistate audit article of the Compact is "voluntary," and would ignore the fact that all member states have adopted the audit article and that numerous audits have been conducted by the Commission. Similarly, the appellees emphasize that the Commission's regulations are "advisory," and neglect to mention that at least eleven members have adopted the regulations, and that such regulations have been employed in numerous multistate audits. The appellees also ignore the many abuses that have occurred under the Compact,[7]

[6] Throughout their brief, appellees claim that appellants' action is based on the Compact "on its face." (Appellees' Br. 2, 17, 55, 57, 70, 76, 80.) However, appellants' complaint stated:

"Statement of Claim

19. The Multistate Tax Compact, in enactment *and in operation*, is in violation of the Constitution of the United States, the constitution of numerous states, and of controlling state law on numerous grounds, including . . ." (App. 7; emphasis supplied).

The section of the complaint which appellees cite (Br. 2) as confining this Court to the face of the Compact asked the court below to:

"Enter preliminary and permanent injunctions enjoining the Multistate Tax Commission and the individual defendants, their successors, agents and employees, and all other persons in active concert and participation with them from implementing and enforcing the provisions of said Multistate Tax Compact, whether through the office of the member states or otherwise, enjoining such Commission from taking any further actions whatsoever, and requiring such Commission to be disbanded." (App. 9-10.)

[7] The claim of irrelevancy is apparently appellees' only reply to the arbitrary tax assessments and arbitrary subpoena campaign conducted by the Commission to force appellants and other taxpayers to "capitulate" to the Commission. *See* appellants' Br. 48-51. Also, contrary to appellees' charge, appellants have cited cases (appellants' Br. 50) ordering the practices of the Commission stopped, although most cases concerning the Compact have been stayed pending decision in this case. Finally, it is not inconsistent,

apparently failing to realize that the potential impact of a law is established by its practical administration. The appellees go so far as to disassociate the Commission from its own official publications and the actions of its Executive Director, General Counsel, and Audit Coordinator. (Br. 78.)

Thus, in effect, the appellees wish this Court to judge the Compact in a vacuum: When appellants discuss the far-reaching potential of a compact intended to transform interstate and international taxation, appellees dismiss these efforts as speculation. When appellants establish that the potential impact of the Compact has been realized, by showing that regulations have been issued, multistate audits conducted, non-business income apportioned, unitary business/combined reporting practices employed, arbitrary assessments recommended, United States treaty partners angered, and abusive subpoenas issued, appellees reply that such "administration" is irrelevant. (Br. 19, 56, 71.) In essence, this Court is asked to ignore what has happened and what may happen under the Compact. Appellants believe, however, that the actual and potential effects of the Compact demonstrate that the Compact's impact should be evaluated by Congress, and that the consent of Congress should be obtained before the Compact is considered valid.[8]

as appellees claim (Br. 75), for appellants to note both that the Compact is a powerful force affecting interstate taxation and that the Compact has produced abusive, inefficient, and confusing practices.

[8] Even if the Court confines itself solely to the terms of the Compact, it will see that the Compact creates a multistate administrative body intended to operate on an ongoing basis; that multistate and multinational audits are authorized; that regulations may be issued and tax assessments recommended; that subpoena powers

III

THE APPELLANTS' ARGUMENTS ARE NOT "IRRELEVANT" OR "ERRONEOUS"

Appellees repeatedly accuse appellants of making "irrelevant," "immaterial," "unsupported," "erroneous," "conjectural," "defective," and "misleading" arguments. (Br. 2, 6, 19, 22, 55, 56, 57, 61, 63, 65, 69, 72, 74, 76, 79, 80.) Although this litany appears so frequently that appellants cannot address each repetition, consideration of several of appellees' charges should establish that appellants have not misled this Court.

1. Appellees assert several times that appellants have made no reference to the provisions of the Compact. (Br. 6, 18, 19.) These assertions are unwarranted, since appellants' entire argument is based on the stated purpose of the Compact (Article I), the creation of

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are granted; and that rules and practices could be expected to develop under all these powers, and pursuant to the Compact's "necessary and proper" clause. (Art. VI, 3 of the Compact; Jur. St. App. E, p. 69a.) More important, it would observe that the Compact is designed to transform multistate taxation. When the power contained in these terms is compared to the consistent practice of Congress with respect to compacts, it is clear that the Compact is an agreement among the states requiring congressional consent under Article I, Section 10.

Thus, for example, although the Interstate Compact to Conserve Oil and Gas is completely "voluntary" and "advisory," Congress has periodically reviewed its operations because, as one commentator observed, "Legally, it has no power; actually, it is the most powerful and respected agency in the oil and gas industry." Leach, *The Interstate Oil Compact: A Study of Success*, 10 Oklahoma Law Rev. 274, 287-8 (1957). Similarly, although the Great Lakes Basin Compact is also "advisory," the Attorney General advised Congress that its consent was needed, because the formulation of recommendations is an important function which may significantly influence events. (Appellants' Br. 23.)

the Multistate Tax Commission by the Compact (Article VI), the regulations authorized by the Compact (Article VII), the multistate audits undertaken pursuant to the Compact (Article VIII), the subpoena powers granted the Commission by the Compact (Article VIII), and the rules, practices, and abuses which have developed and occurred under Compact Articles I, VI, VII, and VIII, as well as pursuant to the Compact's "necessary and proper" clause (Article VI, 3).

2. Appellees also charge that appellants' statement that the Commission's regulations are inconsistent with UDITPA is a misrepresentation. (Br. 79.) Among the citations supporting appellants' statement was an article by the General Counsel of the Commission. Appellees, however, claim that this article did not discuss the validity of the Commission's regulations. Yet the article stated that the Commission has developed regulations, and that industry groups believe "the regulations promulgated by the Multistate Tax Commission in implementing UDITPA do not conform to its provisions dealing with the treatment of dividend income." It then continued:

> "This marked difference between the attribution rules concerning 'business income' and those concerning 'nonbusiness income' lies at the heart of the controversy over the Multistate Tax Commission regulations between COST [an industry group] and the states. The UDITPA distinction between 'business' and 'nonbusiness' corporate income appears to lack any rational basis and has created confusion for taxpayers and tax administrators alike. The Multistate Tax Commission has, therefore, concluded that the distinction should be eliminated by treating all corporate income as apportionable business income. . . . Since UDITPA,

an integral part of the Compact, specifically contemplates the designation of at least some income as nonbusiness income, and since the Multistate Tax Commission is reluctant to recommend amendments to the Compact that would be necessary to implement the 'full apportionment' concept under UDITPA, the Commission has chosen to rely for the present upon its regulations to clear up as much of the confusion as possible." (Footnote omitted.)[9]

3. Appellees state that appellants "take staff statements out of context and cite them in support of statements in the Brief which they do not support." (Br. 78.) To substantiate this, appellees refer to an article by the Executive Director of the Commission which appeared in the Seventh Annual Report of the Commission. Appellants cited the article in connection with the Commission's adoption of practices related to unitary business/combined reporting, and full apportionment, rather than allocation, of dividends and other non-business income. Appellees assert that the article "did not discuss the rules or practices of the Commission." (Br. 78.) Contrary to this assertion, however, the article did discuss the Commission, its rules, and its practices. The article stated that a new system of interstate taxation was needed, which:

> "1. Would impose no limitations upon the states insofar as the apportionable tax base is concerned . . . ; 2. Would treat a business in the same way for tax purposes whether that business was conducted through one corporation or through many corporations, i.e. would apply the unitary business/combination concept; 3. Would provide

[9] *See Dexter*, 29 Vand. L. Rev. 401, 404-405, 407 (1976) (cited in appellants' Br. 27, 48).

guidelines on the basis of which to apply the combination concept; and 4. Would provide for the application of the combination concept on a uniform basis among all of the states. . . .

There currently exists in America only one organization which contains the potential to serve in this suggested capacity. That is the Multistate Tax Commission. It is the only entity which exists as a result of legislative fiat from among many states, the number of which is currently twenty-one, through its charter which is known as the Multistate Tax Compact. . . . As a matter of practice, it already participates in some of the tax administration activities of some of its member states. Included among its activities is a pilot joint audit program under which an audit of a corporate business is performed on behalf of several participating states at the same time. While this has drawn the fire of a large segment of the multicorporate business community, that opposition has mostly been generated by disputes concerning matters to which I have already referred; namely, combination, allocation and apportionment, and exemption of dividends."[10]

4. Appellees charge that appellants have "commingled" (Br. 79) concepts and adopted a "simplistic" (Br. 72, n.31) approach in discussing the differences between standard practices in international taxation, as adopted by the United States and all of its treaty partners, and the unitary business/combined reporting approach employed in many Commission audits. The appellees argue that there is no such standard international practice. Moreover, appellees state that the use of unitary business/combined reporting practices

[10] *See* Seventh Annual Report of the Multistate Tax Commission, pp. 49-50.

cannot encroach upon or interfere with the national interest until a law or treaty affirmatively forbidding such practices is passed (Br. 17, 69, 70, 74), ignoring the problems such practices have caused with our treaty partners and the treaty renegotiations such practices have required. Finally, the appellees assert that unitary business/combined reporting practices are valid and workable (Br. 72, 73), while appellants believe that such practices produce procedural burdens and lead to possible multiple taxation.

On July 19, 1977, Assistant Secretary of the Treasury Laurence N. Woodworth testified before the Senate Foreign Relations Committee on the United Kingdom tax treaty, which contains restrictions on the use of unitary business/combined reporting practices in an international context.[11] Dr. Woodworth noted that such practices produced complaints from our treaty partners, violated the spirit of United States tax treaties, varied from internationally-accepted practices, produced potential misallocations of income and possible multiple taxation, resulted in extraterritorial taxation, and created accounting and other procedural burdens.[12]

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[11] The appellees claim (Br. 73, n.33) that appellants' explanation of the treaty is inaccurate. However, appellants' explanation was taken word for word from the United States Department of State and the Ninth Annual Report of the Multistate Tax Commission. (*See* appellants' Br. 38-39.) It will hardly do to say (as appellees do, in discounting appellants' explanation of unitary business/combined reporting practices and the Commission's opposition to the U.S.-U.K. tax treaty, quoted from the Ninth Annual Report of the Commission) that the practices and policy reported in the Annual Reports of the Commission are not the policy or practices of the Commission. (Br. 78.)

[12] In testifying, Dr. Woodworth explained international tax concepts and practices in a manner similar to appellants. Dr. Woodworth discussed the adverse effects of unitary business/combined reporting practices in the international context, using California's practices as an example. The relevant portions of Dr. Woodworth's testimony are included as Appendix A, at pp. 19-22, below. John Lobdell, Chairman of the Multistate Tax Commission, testified in opposition to the U.S.-U.K. treaty restrictions on unitary business/combined reporting practices, after explaining that the Commission had adopted the policies and practices of California. Senate Foreign Relations Committee Hearing, July 19-20, 1977, not yet printed.

5. The appellees deny several times that the Compact is a regional effort (Br. 56, 63, 64), listing several "associate" states that lie east of the Mississippi River. Such associate states, however, are not members of the compact." Indeed, among the states cited as an associate is Alabama, which has agreed to join the Compact if the consent of Congress is obtained, as required by the Constitution. A map of the present membership of the Compact, based on a map taken from the Ninth Annual Report of the Multistate Tax Commission is printed as Appendix B at page 23, below; it shows rather clearly that the Compact is regionally based.

6. The appellees charge (Br. 56) that much of appellants' argument is "intended to discredit the Compact, the Commission and its work in the eyes of this Court." This charge is made in connection with appellants' observation (appellants' Br. 29) that the Commission frequently adopts rules or practices inconsistent with the laws of the member states, an observation made in discussing the change in voting procedures adopted by the Commission without the approval of the legislatures of the member states. Although appel-

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[13] It should also be noted that the states appearing as *amici curiae* have not joined the Compact, despite their expression of support. In fact, two of the states appearing as *amici curiae* are past members that have formally withdrawn from the Compact.

lees characterize this observation as an attempt to discredit the Commission, they omit any discussion of the change in voting rules, which took place exactly as described by appellants. In fact, the State of Indiana has recently withdrawn from the Compact because the change in voting rules adopted by the Commission conflicted with the Indiana Constitution.[14]

CONCLUSION

No characterization of appellants' argument can alter the fact that the Multistate Tax Compact exists as an "Agreement or Compact" formed by nineteen states without the consent of Congress. The Compact intends to transform interstate and international taxation; it creates a multistate administrative body designed to function on a continuous basis; it calls for the adoption of tax regulations; it authorizes multistate and multinational audits; and it provides for enforcement powers. Moreover, all the practices authorized by the Compact have been effectuated, and abuses have occurred. Thus, in accordance with the words used in the Constitution, and pursuant to the long-standing recognition by Congress of its constitutional responsibility under Article I, Section 10, the powers inherent in the Compact—and already realized in fact—should

[14] *See* Indiana P.L. 90 (S.B. 414), effective July 1, 1977.

not be allowed to continue until the Compact has been reviewed by Congress, and the Compact should be declared invalid until the consent of Congress is obtained as required by the Constitution.

The judgment below should be reversed.

Respectfully submitted,

ERWIN N. GRISWOLD
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036

THOMAS MCGANNEY
14 Wall Street
New York, New York 10005

Attorneys for Appellants

Of Counsel:

RAYMOND J. WIACEK
JONES, DAY, REAVIS & POGUE
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036

RICHARD A. HOPPE
TODD B. SOLLIS
WHITE & CASE
14 Wall Street
New York, New York 10005

SHEARMAN & STERLING
53 Wall Street
New York, New York 10005

September, 1977

APPENDIX A

Testimony of Assistant Secretary of the Treasury, Laurence N. Woodworth *

Background of the Treaty Provision

Over the past several years, a number of our treaty partners have raised the question of state application of unitary apportionment systems to multinational corporate groups based in their countries. They have made essentially two points.

First, they note that our income tax treaties clearly provide that one Contracting State may not tax the business profits of an enterprise which is a resident of the other State unless those profits are attributable to a permanent establishment in the first Contracting State. They perceive the California system as taxing profits which are earned outside California and not attributable to a permanent establishment located in California.

Our treaty partners recognize, of course, that this California practice does not violate the business profits provisions of our existing treaties, because existing treaty provisions apply only with respect to the Federal income tax. Nevertheless, they maintain that state unitary apportionment systems, as applied to foreign corporations, do violate the spirit of our agreements.

Secondly, foreign governments have noted the severe administrative burdens which unitary apportionment systems impose on their corporations. A substantial amount of financial and operating data from each affiliate (in effect the data necessary for a full tax return) must be included in the combined report of the group. When members of the group, and particularly the parent corporation, are located

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* Dr. Woodworth's testimony was reprinted in the Daily Tax Report, No. 140, July 20, 1977, p. J-10.

abroad, much of this information is either difficult or impossible for the taxpayer to obtain.

Foreign parent corporations find it extremely burdensome to submit all of their books and records concerning all of their worldwide activities in a form satisfactory to the taxing state. This is especially true when only one of a large number of their affiliates does business in the state and the books and records are kept in different languages, different currencies, and according to different sets of accounting rules.

Reasons for Treaty Provision

There are several reasons, both substantive and administrative, why the Treasury believes that the application of the unitary system should be limited as it applies to foreign corporations.

Those states which employ the unitary system see it as a logical extension of the standard use of the three factor formula. It is also viewed as a means of dealing with efforts by groups of related corporations to manipulate income and expenses to the detriment of the state treasury. This is a legitimate concern of both Federal and state governments.

The treaty, however, deals explicitly with this issue. Paragraph 1 of Article 9 provides for the adjustment of accounts between related persons to reflect the income and expenses which would be recorded if the related persons were dealing at arm's-length.

And Paragraph 4 of Article 9 is very clear that it does not prevent Federal or state governments from making the arm's length adjustments provided for in Paragraph 1.

In this connection I would note that the arm's-length standard is the internationally-accepted norm for apportioning income between related taxpayers. It is confusing to other countries and disconcerting to international relations when our states use a different standard.

Furthermore, the use of a different method by one jurisdiction will often lead to double taxation. We recognize that the purpose of the unitary system is not to tax the income of the foreign corporation included in the group, but the effect, nevertheless, is often extraterritorial taxation.

Though the administrative resources available to state governments may not permit them to make the same kind of intensive transfer price investigations that the Federal tax authorities are able to make, individual states have access to materials developed by the Internal Revenue Service in its investigations of cases where related companies may not be pricing according to an arm's-length standard.

Moreover, the unitary apportionment system as a means for determining the state taxation base of a multinational corporation is highly imperfect and a poor substitute for the arm's-length standard. Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case.

And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tantamount to taxation by a state government of the foreign income of a foreign corporation.

The misallocation of the tax base under the application of unitary apportionment to foreign corporations can occur for several reasons. For example, labor costs vary substantially among countries—very much more so than among regions in the U.S. If two affiliates, one in California and one in, say, Hong Kong, are engaged in essentially the same activities, the Hong Kong labor cost element in the formula will probably be lower than the California labor cost. A disproportionate amount of income will be appor-

tioned to California. Changes in exchange rates can have a similar effect.

Some state governments have suggested that the treaty provision will result in a large revenue cost to unitary taxation states. If, in fact, there is a substantial revenue loss when an arm's-length pricing standard replaces unitary, this may be an indication that unitary apportionment does, in fact, result in unjustifiable extraterritorial taxation.

We also perceive a major problem in the extensive information required by the tax authorities applying unitary apportionment systems. If the necessary information is not provided by the taxpayer, the state authorities reconstruct accounts on the basis of whatever information they can obtain from public sources, such as reports to shareholders. Tax liability calculated on the basis of such reconstructed accounts is, at best, arbitrary, and may very well be unfair.

If the parent corporation operates in the taxing state, it is of course possible for the taxpayer to provide accurate information and avoid an arbitrary result. But if the taxpayer is a subsidiary of a foreign parent corporation, or stands in a brother-sister relationship to a foreign affiliate, the submission of accurate data may not be within the taxpayer's power.

The Administration is not alone in considering the issues raised by the unitary system. Legislation, known as the Jones Amendment, was proposed in the House during this past congress, and would exclude all foreign corporations from states' unitary tax bases. The Jones Amendment was referred to a special task force of the Ways and Means Committee on foreign source income. The task force, chaired by Congressman Rostenkowski of Illinois, has recommended that "States be precluded from taking into account, under the unitary method or under any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income is subject to Federal income tax."

APPENDIX B

CURRENT MEMBERSHIP OF THE MULTISTATE TAX COMMISSION

This map is based on a map printed in the Ninth Annual Report of the Multistate Tax Commission, p. xviii. Wyoming and Indiana have withdrawn since this Report was published, and they have been deleted as members on the map as reproduced here. "Associate" states also are not shown here.